

Reporting season for “the big four” – taking the temperature of the Australian economy

Summary

- The latest round of reporting for the big four Australian banks—NAB, Commonwealth Bank (CBA), Westpac and ANZ—highlights a few points of weakness in the economy.
- Consumers have been experiencing tougher times, with a mild increase in mortgage and personal loan arrears; but the level is not high enough to call it the start of a downturn.
- Retail, tourism and manufacturing are also showing signs of stress.
- However, in general, recovery from the global financial crisis (GFC) continues to drive down the banks’ loss forecasts.

The rise in delinquencies over the first half of 2011 could be due to increased stress on household budgets due to the rise in interest rates in late 2010 and relatively soft market conditions over the period. It can also partly be attributed to statistics, however. From 2007-2009, the big four underwrote a greater number of mortgages—mortgage growth in that period was 15%, compared with closer to 6% currently. The greater number of mortgages will likely mean a greater number of delinquencies, even if the proportion of delinquencies remains the same.

Geographically, Queensland has proven to be the main underperformer in terms of mortgage arrears for CBA, Westpac and ANZ. The higher arrears can be attributed to:

- The impact of the strong Australian dollar on tourism;
- Slowing construction;
- Higher than national average unemployment; and
- The floods of early 2011.

Westpac has also noticed increased stress for borrowers in Western Australia, which some have attributed to rising house prices due to the surge in mining, combined with a relaxation of credit requirements and ramp-up of speculation.

Residential Mortgage-Backed Securities

The residential mortgage-backed securities (RMBS) market—bonds backed by a pool of mortgages on residential properties—has remained relatively stable over the past financial year. However, we do note a small deterioration in terms of asset quality in the first half of 2011 in line with the banks’ mortgage delinquency results discussed above. Rating agency, Moody’s Investor Services has calculated the national delinquency rate increased to 1.67% from 1.36% between March 2010 and June 2011.

Despite the Queensland floods and rise in rates in the second half of 2010, the effect on RMBS has been minimal. These securities have healthy levels of subordination (or default cushion), little exposure to flood-affected properties and solid levels of available excess spread (funds remaining after payments to bondholders, expenses and losses are covered).

Moody’s has reported RMBS delinquencies up marginally in 2011 due to the aftermath of the Queensland floods and seasonal factors such as Christmas spending and petrol price increases. Going forward, Moody’s expects marginal deterioration in delinquencies and losses due to the “two-speed” nature of the economy. It believes the resources sector will be a key contributor to the rate of growth while the performance of other sectors such as retail and trade-dependent manufacturers will be sluggish due to weak consumer confidence and the high Australian dollar.

Residential mortgage asset quality improving

The big four banks have generally seen an improvement in mortgage asset quality over the past financial year, although there has been some recent deterioration (from September 2010 to March 2011) due to global volatility.

The big four experienced mixed results in terms of mortgage payment arrears of more than three months (90+ day delinquencies). CBA had consistently higher delinquency rates compared with the previous half and full years, but NAB had lower rates for both periods. Delinquencies peaked at the end of the first half of financial year 2011 for Westpac and ANZ, but then dropped overall at the end of the September quarter (Q3). The delinquencies are higher than in Q3 last year, but the rise is minimal at around 0.1%. The slight improvement seen in Q3 may be due to better collection initiatives.

Westpac claims that this has offset the mortgages written in 2008/2009, which were more concentrated in Queensland and had a higher proportion of low-documentation loans.

It is important to note the relative strength of the current Australian mortgage market—in overall terms, delinquencies are still very low and below industry benchmarks. In fact, of all the mortgage loans on their balance sheets, 90+ day delinquent loans only account for about 1% for CBA and 0.5% for the other three banks (see table below).

90+ day delinquencies for the four major banks

| Market Share Rank | Bank | Q3 2011 (approx. %) | Difference from H1 2011 (approx. %) | Difference from FY 2010 (approx. %) |
|-------------------|---------|---------------------|-------------------------------------|-------------------------------------|
| 1 | CBA | 0.73 | Flat | +0.08 |
| 2 | Westpac | 0.55 | -0.04 | +0.08 |
| 3 | NAB | 0.53 | -0.08 | -0.14 |
| 4 | ANZ | 0.55 | -0.05 | +0.15 |

Source: NAB, ANZ, CBA, Westpac.

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Fact Sheet

Stressed market sectors

Asset quality has generally improved, with new stress easing and companies returning to performing after working through the GFC problems. However, some sectors are still finding it tough. The key area under pressure is commercial property, to which the big four banks have been steadily lowering their exposure. The sector has stabilised and trends are generally positive, but banks are still dealing with the work-out of previously downgraded assets and falling property values in certain markets such as southeast Queensland.

Commercial property has been under stress mainly due to the volatile nature of planning, construction and development. In commercial property, the time lags last longer and borrowers do not have the same disincentives to default compared with residential loans. In addition, vacancy rates are high, with prices and rents having not entirely recovered since the GFC.

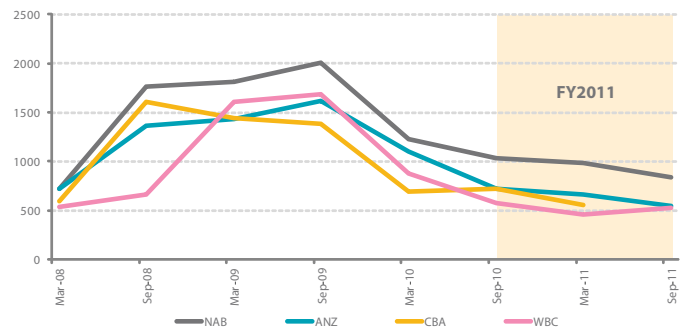
Other sectors highlighted by the banks as underperforming include the retail sector, which faces challenges from subdued consumer confidence, competition from online vendors and the reining in of discretionary spending. Tourism and manufacturing also face challenges due to the impact of the current strength of the Australian dollar, making the country expensive and less competitive than overseas markets. The current uncertainty in global markets is keeping the Australian dollar up, meaning that markets that are vulnerable to its appreciation are having a tough time of it. In our view, the domestic currency is likely to remain strong, certainly relative to the “old normal” which will continue to put pressure on these areas of the economy.

Loan loss provisioning has dropped

The banks have needed to provision fewer funds to cover losses on loans compared with the last financial year (see chart below). This is largely due to the recovery of provisions that they used for the Queensland and Victoria floods, as well as the Christchurch earthquake. In addition, companies have been returning to the performing category following the GFC and there has been improving asset quality with associated repayments and recoveries in institutional business.

NAB has noted improved conditions in personal banking with lower delinquency rates and seasonal influences positively affecting unsecured lending.

Loan loss provisioning



Source: NAB, ANZ, CBA, Westpac. Note that CBA releases data on a different schedule to the other banks – currently data is only available to March 2011.

Conclusion

The banks’ latest reporting round shows that consumers have been suffering slightly of late, with a mild increase in mortgage and personal loan arrears. Retail, tourism and manufacturing have also been under pressure. This is partly due to the impact of the strong Australian dollar on tourism and the Queensland and Victoria floods, with retail suffering from subdued consumer confidence.

However, there are positive to take from the results–recovery from the GFC continues to drive down the banks’ loss forecasts and mortgage asset quality has generally improved over the past financial year. The Australian mortgage market is still strong compared with other developed countries, with still very low delinquency levels of 1% or less.

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